MassMutual

Buy-Sell Planning*

Strategies for Competitive Businesses

Preserve Your Business' Future

The business interest is often the single largest asset of a closely held business owner's estate. It is often used to provide the majority of current income and support to the business owner's family. Understanding the need for planning, then developing and implementing a succession plan is critical to the continued well-being of the family in the case of the death or disability of a business owner.

Planning in the Event of the Owner's Death

The most important guarantees to you as a business owner are the continuity of the business upon the death of another owner and the certainty that your estate will have an immediate guaranteed buyer for your interest at a price that represents fair market value. These guarantees require sound advance planning. In the absence of such preparation, problems can arise.

Problems for the Surviving Owners

The deceased owner's heirs may:

- Insist upon an active role in management — whether or not they have the capability or compatibility.
- Insist on dividends being paid, which may cause double taxation and impairment of the firm's ability to expand.
- Threaten to (or actually) sell to "outsiders."
- Call for liquidation if they can't get their way — resulting in the loss of jobs as well as income and wealth-building opportunities for the surviving owners.

Employees may:

- Feel insecure, and their morale may sag, along with their productivity.
- Terminate employment — further crippling the firm, causing costly replacement problems.

Creditors may:

- Tighten up on credit in light of the firm's weakened and uncertain condition.

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Provide for Your Family and Heirs

Without a buy-sell arrangement:

- They are left with an asset of real value that has no guaranteed market, and they may be forced to sell at distressed prices.
- They have lost the deceased owner's salary but will receive no income to replace it.
- They may encounter delays in administration of the estate caused by the attempts to sell the business.

Fortunately, these undesirable consequences can be minimized through the use of a buy-sell arrangement.

A **buy-sell agreement** is a legally binding contract that requires one party to sell and another party to buy a particular ownership interest in a business in the event of the death, disability, or retirement of a partner or stockholder or upon certain other triggering events as specified in the contract. These agreements may be used by any type of business entity: sole proprietor, corporation, partnership, limited liability company (LLC), etc.

Under this arrangement, when an owner dies, if the provisions are carried out, the plan will ensure the prompt and orderly sale of his or her business. This benefits your family, your heirs, and the surviving owners of your business.

While the buy-sell agreement legally requires the survivors to buy and the estate to sell, the arrangement could fail if the survivors do not have the financial capacity to make the purchase following an owner's death. Life insurance can be an excellent way to fund a buy-sell agreement.

Protect Your Business and Family

There are several design options available and shown in detail below that can help you tailor the arrangement to meet your specific objective.

DETAILED COMPARISONS

	Entity Arrangement	Cross-Purchase Arrangement	Trusteed Cross-Purchase Arrangement	Wait-and-See Arrangement
Purchaser of Interest	The business	Surviving owner(s)	The trustee collects the insurance proceeds and distributes to surviving owners who purchase an owner's interest at an agreed upon price upon death, disability or retirement.	The business has the first option to purchase and the remaining owners have the second option to purchase. The business must purchase any remaining interests.
Seller of Interest	Withdrawing owner or deceased owner's estate	Withdrawing owner or deceased owner's estate	Withdrawing owner or deceased owner's estate	Withdrawing owner or deceased owner's estate
The Arrangement	Business purchases an owner's entire interest at an agreed upon price, upon death, disability, or retirement.	Surviving owners purchase an owner's entire interest at an agreed upon price, upon death, disability, or retirement.	Trustee collects insurance proceeds and distributes to surviving owners who purchase an owner's entire interest at an agreed upon price, upon death, disability, or retirement.	Depending on whether option to purchase is exercised, either the business engages in an entity arrangement purchase or the surviving owners engage in a cross-purchase arrangement.
Legality of the Arrangement	Typically, state law requires a corporation to redeem from surplus only.	Usually no restrictions.[1]	Usually no restrictions.[1]	Restrictions may apply if entity arrangement elected. See entity arrangement.
Life and Disability Buy-Sell Insurance Policies	Business is applicant, owner, premium payor, and beneficiary of a policy on the life of each owner in an amount sufficient to meet the price in the agreement.	Each owner is applicant, owner, premium payor, and beneficiary of a policy on each of the other owners (unless a trust is used). If more than two parties, then a trusteed cross-purchase arrangement is recommended for disability underwriting.	Trust is owner, premium payor, and beneficiary of one policy on each of the owners.	If the business has the obligation to buy, the business will typically own policies, as in entity arrangement. If the survivors will likely exercise their personal options then insurance arrangement will follow cross-purchase arrangement.
Number of Policies Required	Only one policy per owner is required.	Formula for number of policies needed is n(n-1), where n = number of owners (unless a trust is used).	Only one policy per owner is required.	This will depend on if entity arrangement or cross-purchase arrangement is used.

Premiums	Business cannot deduct premium payments.	Owners cannot deduct premium payments.	Trust cannot deduct premium payments.	Premiums cannot be deducted.
Claims of Creditors[4]	Business creditors may enforce a claim against both the cash value and the proceeds of business-owned life insurance.	Business creditors cannot reach cash values or proceeds of policies owned by individuals; however, each owner's creditors can.	The policies and cash value are generally not subject to the business' creditors.	See entity or cross-purchase arrangement as applicable based on policy ownership.
Taxability of Insurance Proceeds	Life insurance proceeds are generally received income tax free. Disability income insurance benefits may be received tax free.	Life insurance proceeds received by surviving owners are income tax free. Disability income insurance benefits may be received tax free.	Life insurance proceeds received by surviving owners are income tax free. Disability income insurance benefits may be received tax free.	Life insurance proceeds received are income tax free. Disability income insurance benefits may be received tax free.
Taxability of Proceeds Received by Former Owner	If the transaction qualifies as a complete redemption of a shareholder's stock, the payments received generally will be treated as a capital gain or loss. When the buy-out results in a termination of the disabled partner's interest, it is taxed as a liquidation of his or her interest resulting in gain only to the extent of cash received (if any).	If the buy-out is a cross-purchase between the shareholder-employees, it will also be considered a capital transaction and taxed accordingly. The disabled owner is taxed only on the gain from the sale of the business interest. Where the buy-out is a cross-purchase between partners, it is taxed as a sale of the partner's interest.	Same as cross-purchase arrangement	See entity or cross-purchase arrangement, depending on the identity of the buyer.
Value of Insurance Proceeds Includable in Owner's Estate	If business is policyowner and beneficiary, only the value of business interest, not death proceeds, is includable.[5] Business interest value includes pro-rata portion of insurance proceeds.	Death benefit not included. Value of policies on surviving owners includable in estate of deceased owner.	Death benefit not included. Value of policies on surviving owners includable in estate of deceased owner.	See entity or cross-purchase arrangement as applicable based on policy ownership.

Tax Basis of Purchaser	In a C Corporation, there is no increase in basis to surviving stockholders on redemption of decedent's interest. Value of survivor's stock is increased, but not the basis. When the surviving stockholder later sells the stock, this will result in greater taxable gain. In an S Corporation using cash accounting, it is possible for surviving shareholders to increase basis by electing a short tax year when a stockholder dies. In a partnership/LLC, an increase in basis is achieved when insurance proceeds are allocated to capital accounts of surviving owners.	Basis of purchasing owner is increased by the price they pay for the decedent's interest. Subsequent lifetime sale results in less taxable gain to them, due to the basis increase.	Basis of purchasing owner is increased by the price they pay for the decedent's interest. Subsequent lifetime sale results in less taxable gain to them, due to the basis increase.	See entity or cross-purchase arrangement as applicable based on policy ownership.
Family Owned Business Attribution Rule	When related persons own stock and where a beneficiary of an estate owns stock, a redemption may result in a dividend taxable to the estate.	No dividend problems when stock is purchased by surviving stockholders.	No dividend problems when stock is purchased by trustee.	See entity or cross-purchase arrangement, depending on the identity of the buyer
Transfer of Policies	Transfer of policies to surviving owners at death of one owner is not necessary (all policies are owned by the business).	The estate of the deceased owner will own policies on the lives of the surviving owners. Surviving owners may purchase policies on their lives from estate without transfer-for-value (TFV) problems.[1]	For corporate arrangements (but not partnerships) there is a possible TFV issue when the deceased's interest in survivor's policies are redistributed.	See entity or cross-purchase arrangement, as applicable based on policy ownership.
Transfer-for-Value: Change of Arrangement to Cross-Purchase	In a corporation, there is a TFV problem if the policy is transferred to a non-insured shareholder.[2] In a partnership (or LLC taxed as a partnership), there is no TFV problem because transfers to and from a partnership or its partners meets an exception to the TFV rule under.[3]	N/A	N/A	If business owned policies to begin with, see entity arrangement.

Transfer-for-Value: Change of Arrangement to Entity Purchase	N/A	No TFV problem if the policy is transferred to a company where the insured is an officer or a shareholder.[2] In a partnership (or LLC taxed as a partnership), there is no problem because transfers to and from a partnership or its partners meets an exception to the TFV rule.[3]	If policies moved from trust to business, see cross - purchase arrangement.	If policies owned by co-owners originally, see cross-purchase arrangement.
Transfer-for-Value: Change of Arrangement to Trusteed Cross-Purchase	No TFV problem if the business is a partnership or if the owners are partners in an unrelated partnership (or an LLC taxed as a partnership) at the time of the ownership change. If it's a corporation, the policies can first be transferred to the insured and then to a trust also resulting in no TFV.	No TFV problem if the business is a partnership or if the owners are partners in an unrelated partnership (or an LLC taxed as a partnership) at the time of the ownership change. If it's a corporation, the policies can first be transferred to the insured and then to a trust also resulting in no TFV.	N/A	See entity or cross-purchase arrangement, as applicable based on policy ownership.
Change of Arrangement to Wait-and-See	Typically the policies will not move even though the buy-sell agreement changes.	Typically the policies will not move even though the buy-sell agreement changes.	Typically the policies will not move even though the buy-sell agreement changes.	N/A

[1] If the corporation is a PC, or Professional Corporation, a stock purchaser must be a licensed professional in the state of incorporation of the entity.

[2] Due to changes recently made as of October 31, 2019 to the Tax Cuts and Jobs Act (TCJA) 2017 regarding the transfer-for-value rule, you should consult your personal tax and legal advisor before transferring a life insurance policy.

[3] (IRC) § 101(a)(2)(B).

[4] State law deals with life insurance creditor protection.

[5] Recent court cases held that life insurance death proceeds payable to a corporation to fund a stock redemption buy-sell arrangement increased the value of the stock included in the decedent shareholder’s estate. Business owners utilizing this type of arrangement should consult with their tax and legal advisors to assess the impact of this decision on their buy-sell arrangement and future planning needs.

Factors to Consider in Determining the Form of Buy-Sell Arrangement

The decision to establish an entity or cross-purchase arrangement may require several factors to be weighed. This chart may provide some additional insight.

Factor	Consideration
Number of Parties	The larger the number of parties, the more complex the establishment and administration of a cross-purchase arrangement will be. This would include a far greater number of insurance polices if that were the funding vehicle.
Age and Ownership Differential	The greater the age difference, the larger the financial obligation imposed upon the younger/minority stockholder or partners, under a cross-purchase arrangement. An entity plan may be preferable since it allows for a pooling of the premium obligations within the business (corporate dollars).
Life Insurance Funding	An entity purchase arrangement would not necessitate the business owners personally paying premiums for funding life insurance.[6] However, split dollar life insurance may assist in funding a cross-purchase.
Cost Basis	Since a cross-purchase arrangement generally will result in the surviving owner receiving a higher cost basis[7] for the business interest, the survivor would incur lower capital gain for any subsequent sale. In a partnership or LLC taxed as a partnership (as noted previously) whether the buy-sell arrangement is structured as an entity or a cross-purchase, the surviving owners' basis will increase by the purchase price they paid for decedent's interest.
Attribution of Ownership Rules	Due to potential dividend taxation under IRC § 301, redemption may be inadvisable for a family corporation. Therefore, a cross-purchase arrangement may be the only viable approach.
Possibility of Plan Change	If the parties anticipate that they may change from one type of arrangement to another, the effect of the transfer-for-value rule[1] {IRC § 101 (a)(2)} favors the initial establishment of a cross-purchase arrangement for a corporation, since the policies could later be transferred to the corporation to fund a redemption without creating a transfer-for-value. However, the parties normally would not be able to transfer the policies from the corporation to the non-insured stockholders to fund a cross-purchase arrangement, without creating a transfer-for- value and, therefore, subjecting the death proceeds to income taxation. In a partnership or LLC taxed as a partnership, the rule is not as daunting since transfers of policies amongst partners in an entity taxed as a partnership (including LLCs taxed as partnerships) or to or from a partnership or LLC itself meet an exception to the transfer-for-value rule under IRC § 101(a)(2)(B). Thus there is great flexibility to transfer policies to any partner or the partnership itself at any time before the insured passes without the death benefit incurring an income taxable result.
Tax Bracket	If the corporate tax bracket is higher than the policyowner's individual tax bracket, a cross-purchase arrangement would be the logical choice and vice versa. For a partnership and LLC taxed as partnership, the tax bracket would be the individual's since there is no separate tax bracket for this type of entity but rather just the individual tax bracket.

[6] Recent court cases held that life insurance death proceeds payable to a corporation to fund a stock redemption buy-sell arrangement increased the value of the stock included in the decedent shareholder's estate. Business owners utilizing this type of arrangement should consult with their tax and legal advisors to assess the impact of this decision on their buy-sell arrangement and future planning needs.

[7] It is possible to achieve an increase in basis for S Corporation surviving stockholders with a stock redemption plan if the corporation uses cash basis accounting. This is done by the survivors electing a short fiscal year when a stockholder dies. IRC § 1377, 1367(a).

Planning in the Event of the Owner's Disability

You and your business partners are a team. What if a disability took one of you out of the picture?

The benefits of a well-crafted and appropriately funded buy-sell arrangement, as triggered upon the death of a business owner are generally recognized and appreciated. Unfortunately, many business owners who are concerned about selling their business interest upon death are not as concerned about selling their business interest if they become totally disabled. This mindset is unfortunate because the problems, with respect to the disposition of a business interest, can be as detrimental upon total disability as they are upon the business owner's death.

Preserve Your Business' Future

The total disability of a business owner places the owner in the unenviable position of having to maintain an interest in the business while the owner is physically or mentally disabled. This can create a severe strain for all the parties who are involved in the business.

- First, the owner who is disabled obviously must struggle with two burdens at once — the disability and the business. As a result, the financial burden created by the disability requires protection of both family income and daily business operation expenses, not to mention the possibility of a sale of the disabled owner's interest in the business.
- Second, the family of the disabled owner must witness what they believe is an unnecessary struggle.
- Third, the business associates of the disabled owner may feel that the business should not have to operate without able-bodied management.
- Finally, both the creditors and the customers of the business may experience an unsatisfactory change in the policies and practices of the business after the owner becomes disabled. Thus, all of those involved in the business may be adversely impacted if the disabled owner of a business interest attempts to stay with the business notwithstanding the incapacity.

A Possible Solution

To help minimize undesirable consequences, a buy-sell arrangement that includes a disability buy-out provision with terms similar to the purchase of the business interest at death may be used. Of course, there are circumstances existing upon the disability of the business owner which may not be present at the owner's death. However, these differences should not obscure the advisability of including disability buy-out provisions in the agreement. As part of the agreement, the purchaser or purchasers should agree to buy, and the business owner should agree to sell the interest in the business if the business owner becomes totally disabled. There are several factors to consider in preparing for the potential disability of a business owner:

- The arrangements required to purchase a disabled owner's interest.
- The definition of disability for this purpose.
- The length of time the owner must be disabled before the buy-out is triggered.
- Whether the buy-out is mandatory or optional, and how the agreement is to be enforced.
- With respect to the business interest itself, how its value will be determined and by whom, and when (at the time of disability or later when the buy-out triggers).
- Whether the purchase price is fair and reasonable.
- Whether the buy-out is made in a lump sum or under an installment sale.

In a disability buy-out agreement, the parties should be clearly identified with their obligations to buy and sell in the event of an owner's disability. Also, the price or the method of establishing the price should be specifically set forth. Funding the buy-out with a disability income insurance policy should help ensure that money will be available to execute the purchase (subject only to the insurer's ability to meet its financial obligations, all premiums being paid when due, etc.).

A disability buy-out arrangement is specifically designed to help buy out the business interest of an active owner who becomes totally disabled. The potential conflict between the active owners and the disabled owner may be avoided if they enter into a properly drawn disability buy-out agreement and fund it appropriately. Such an agreement provides for the acquisition of the disabled owner's share by the surviving business associates and for the payment to the disabled owner of an agreed upon price for the business interest.

Protect the Business and the Family

As with any buy-sell arrangement, the buy-out of a disabled owner's interest can occur in one of three ways — by an entity agreement where the business itself buys back the interest, by a cross-purchase agreement where the remaining owners buy the disabled person's interest, or by a trusteed cross-purchase agreement.

There are three basic forms of DI buy-sell agreements:

1

Entity Agreement

An entity purchase buy-sell agreement is a legal agreement between a business entity and its owners. To illustrate how it works, assume a business is owned equally by A and B. They each enter into an agreement with the business for the purchase and sale of their respective interests. Typically, the agreement is binding, in that it obligates both A and B, and their estates to sell, and the business to buy, upon the disability of either one of them.

The agreement establishes a value of the business interest to be bought. In the event of an owner's disability, the agreement typically provides for the transfer of the ownership interest in exchange for cash or cash and an installment note. Once the departing owner receives the cash, the business interest is transferred to the business.

2

Cross-Purchase Agreement

A cross-purchase buy-sell agreement is a legal agreement among the owners that provides for the planned disposition of their interests in the event of a disability. To illustrate how this works, assume a business is equally owned by two individuals, A and B. They enter into an agreement providing for the purchase and sale of their respective interests. Typically, this agreement is binding and obligates both parties, or their representatives, to either buy or sell upon the disability of either one of them.

There may be situations in which an entity purchase agreement could be preferable even with two or three owners. For example, where the oldest owner has the largest interest in the business, a cross-purchase agreement would require the younger owner, usually lower-paid, to make the larger premium commitment. An entity purchase agreement would pool the premium burden and be easier on the younger owner.

3

Trusteed Purchase Agreement

A trusteed cross-purchase agreement is a legal agreement between a third- party trustee and the partners or stockholders that provides for the planned disposition of their ownership interests in the event of a death, disability, or retirement. The trustee or escrow agent acts to carry out the obligations of the partners or shareholders.

Why a Buy-Out is Funded with DI Insurance

The same rationale for using a life insurance policy to fund a buy-sell obligation upon the death of a business owner applies to using a disability policy to fund a buy-out obligation upon the total disability of a business owner. Admittedly, depending on the value and the cash position of the business, it may be possible to use current cash or borrowed funds to help purchase the disabled owner's business interest. However, from a simple economic point of view, using current cash is often an expensive way to purchase a business interest. Even if the business has sufficient capital, insurance may still be the best way to fund the buy-out. Because the purchase of a business interest is not a deductible expense, after-tax dollars are needed. For example, in a 25% tax bracket, it takes $133,333 before-tax dollars to leave $100,000 after taxes.

Premiums for disability buy-out (DBO) insurance are a non-deductible expense. The benefits, however, are generally received income tax free[8] and can be used for the business purchase. Upon the disability of an owner, the business may be obligated to continue to carry the disabled owner and pay salary and benefits for an indefinite period of time. In addition, the disabled owner is often still entitled to a share of profits and maintains his or her share of the overall business. The DBO insurance policy provides a means to buy the interest of a disabled owner, generally over a period of years, once it is evident the disabled owner is not going to return. The payment can be a monthly amount or a lump sum.

[8] Footnote

IMPORTANT TAX FACTORS TO CONSIDER

Factor	Consideration
Taxation of DI Benefits	Whether the disability buy-out arrangement is structured as an entity, cross- purchase, or trusteed cross-purchase agreement, the taxation of premiums and benefits is the same. The premiums paid are not tax-deductible but the benefits are generally received income tax free.
Taxation of a DI Buy-Out Between Corporate Entity and Disabled Owner (Entity Purchase)	The actual purchase of the business interest is likely to have income tax ramifications for both buyer and seller. When the buy-out is between a corporate entity and a disabled owner and the transaction qualifies as a complete redemption of a shareholder's stock, the payments received generally will be treated as a capital gain or loss.
Taxation of a DI Buy-Out if Cross-Purchase	If the buy-out is a cross-purchase between the shareholder-employees, it will also be considered a capital transaction and taxed accordingly. The disabled owner is taxed only on the gain from the sale of the business interest.
Taxation of Buy-Out Between Partnership (LLC Taxed as a Partnership) and Disabled Partner Interests	When the buy-out is between a partnership and a disabled partner and results in a termination of the disabled partner's interest, it is taxed as a liquidation of his or her interest.
Taxation of Buy-Out if Cross-Purchase Between Partners	Where the buy-out is a cross-purchase between partners, it is taxed as a sale of the partner's interest.

What is the Definition of Disability?

The concept of "disability" as it relates to an owner's active participation in a business is often far more difficult to define and describe than are most other buy-sell triggering events. Setting forth the conditions under which an individual is deemed to be disabled is essential to a successful arrangement.

An injury or sickness may leave a person unable to work for days, months, years, or for the rest of his or her life.

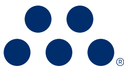
Basically, when an active business owner is disabled for a period in excess of one year (more or less, depending on the business), the disability, whether "temporary" or "permanent" for medical purposes, will affect the business as if it were permanent.

Business considerations will usually dictate the replacement of an unproductive and disabled individual; meanwhile, the disabled owner needs the assurance that he or she will receive fair payment for his or her business interest. A disability buy-out arrangement funded with disability income insurance can be a logical solution.

The success of a disability buy-out arrangement may be largely dependent on the insurance used to fund it. Thus, the most logical definition of disability to use in the agreement is likely to be the definition contained in the insurance policy that will fund the buy-out. This places upon the insurance company the burden of determining whether the owner's disability meets the policy's definition, thus avoiding potential disagreements among the owners.

Policies may define total disability as the inability to perform the duties of the insured's regular occupation or a reasonable occupation based on the insured's education, training, or experience. The individual's ability to contribute in a meaningful way to the business is what you want to insure for the purposes of a disability buy-sell arrangement. Even if the owner can work in a different, unrelated business, he or she will want to continue to be deemed totally disabled for purposes of the buy-out and coverage under the policy because of his or her inability to work in the former business.

At Massachusetts Mutual Life Insurance Company (MassMutual), we have a variety of insurance products that can be used with a buy-sell arrangement. With our quality products and support, we are ready to show you how a buy-sell plan can work for you.



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